

## Repairing Façade Easements: Is this the Gift that Launched a Thousand Deductions?

*“When we build, let us think that we build forever.”<sup>1</sup>*

### I. Introduction

Preservation of America’s built environment is an important, and costly, endeavor. Federal law provides various incentives to encourage preservation and to help defray the cost. The Internal Revenue Code (the “Tax Code”) offers preservation incentives, including *inter alia* a charitable contribution deduction for the gift of a qualified conservation contribution.<sup>2</sup>

The National Register of Historic Places (the “National Register”) encourages the identification of buildings worthy of preservation.<sup>3</sup> Many building owners protect their historic buildings by donating façade easements to charities dedicated to the preservation of our architectural heritage. Façade easements may be used to protect a diverse array of historic buildings: commercial buildings, personal residences, and even barns. A façade easement gives the charity a property interest and allows it to control changes made to the façade.<sup>4</sup>

Some façade easements include a covenant in which the grantor assumes sole responsibility for maintaining the façade.<sup>5</sup> The covenant may require the donor to keep the building in the state of repair existing at the time of the grant or in some other

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<sup>1</sup> JOHN RUSKIN, THE SEVEN LAMPS OF ARCHITECTURE 186 (Dover Publications, Inc. 1979) (1880).

<sup>2</sup> I.R.C. § 170(f)(3)(B)(iii) (2000).

<sup>3</sup> National Historic Preservation Act, 16 U.S.C. § 470a (1980). For purposes of this article the phrase “historic building” shall refer to a building listed on the National Register.

<sup>4</sup> I.R.C. § 170(h)(1), (4)(A)(iv). The extent of the charity’s control depends on the terms of the façade easement. Some easements grant the right to control not only changes to the façade but also changes to the building’s structure or to the site. *See e.g.* THOMAS S. BARRETT & STEFAN NAGEL, MODEL CONSERVATION EASEMENT AND HISTORIC PRESERVATION EASEMENT 96-98 (1996).

<sup>5</sup> *See e.g.* BARRETT & NAGEL, *supra* note 4, at 96.

specified condition.<sup>6</sup> The covenant may also specify the standard to which repairs must conform.<sup>7</sup> For example, the grantor's covenant to maintain the façade contained in one model easement reads as follows:

Grantor agrees at all times to maintain the Buildings in the same structural condition and state of repair to that existing on the effective date of this Easement. Grantor's obligation to maintain shall require replacement, repair, and reconstruction by grantor whenever necessary to preserve the Buildings in substantially the same structural condition and state of repair as that existing on the date of this Easement. Grantor's obligation to maintain shall also require that the Property's landscaping be maintained in good appearance with substantially similar plantings, vegetation, and natural screening to that existing on the effective date of this Easement. The existing lawn areas shall be maintained as lawns, regularly mown. The existing meadows and open fields shall be maintained as meadows and open fields, regularly bushhogged to prevent the growth of woody vegetation where none currently grows. Subject to the casualty provisions of paragraphs 7 and 8, this obligation to maintain shall require replacement, rebuilding, repair and reconstruction of the Buildings whenever necessary in accordance with *The Secretary of the Interior's Standards for Rehabilitation and Guidelines for Rehabilitating Historic buildings* (36 C.F.R. §67), as these may be amended from time to time....<sup>8</sup>

This article explores the impact of such a covenant on the characterization for tax purposes of expenditures to maintain the façade. Because the general rule imposes the obligation to repair property subject to an easement on the easement holder,<sup>9</sup> this article concludes that the covenant represents a donor's promise to make gifts in the future and that payments pursuant to such a promise constitute, to the extent of the charity's obligation to repair, additional charitable contributions.

Part II of this article discusses the rules for determining if a building is historic and worthy of listing on the National Register. Part II also discusses the relevant rules

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<sup>6</sup> *Id.* at 96-97.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* Whether such agreement runs to future owners is questionable, Rosenberg & Jacobstein, *Historic Preservation Easements: A Proposal for Ohio*, 7 U. Dayton L. Rev. 313, 334 (1982), unless the state enabling act so provides. See e.g., Uniform Conservation Easement Act § 4, 12 U.L.A. 179 (1981).

<sup>9</sup> See discussion *infra* notes 67-71 and accompanying text.

regarding easements and charitable contributions. Part III explores the question of whether a charitable easement holder should be obligated to repair the façade and, assuming the answer is yes, why repairs made by the donor are additional charitable contributions. Part IV contains a suggested reform, which, if adopted, would provide an administratively convenient method to determine the amount of the charitable contribution, a method that would treat all donors and the government consistently and fairly. Part IV also explains the impact of adopting such reform.

## II. Background

### A. Identifying Historic Buildings

The National Register, which was created as part of the National Historic Preservation Act of 1966,<sup>10</sup> encourages the preservation of America's built environment by identifying and listing buildings determined to have historic significance.<sup>11</sup> The National Register lists buildings of local, state or national significance,<sup>12</sup> including all National Historic Landmarks.<sup>13</sup> A building may be listed due to its association with a significant historic event<sup>14</sup> or person,<sup>15</sup> or due to its architectural importance.<sup>16</sup> An architecturally significant building is one that embodies the distinctive characteristics of a

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<sup>10</sup> 16 U.S.C. § 470a (2000) *et. seq.*

<sup>11</sup> 16 U.S.C. § 470a(a)(1)(A). Although this article is only concerned with listed buildings, the actual scope of the National Register is much greater. The National Register is a list of “district, sites, buildings, structures, and objects significant in American history, architecture, archaeology, engineering and culture.” *Id.* See also, 36 C.F.R. § 60.1(a) (1981).

<sup>12</sup> 36 C.F.R. § 60.1(b)(3) (1981). A building is never listed on the National Register over the objection of its owner. 16 U.S.C. § 470a(a)(6). If an owner objects, the building is denominated as eligible for listing. *Id.* Although entitled to some benefits associated with listing, *see e.g.* 16 U.S.C. § 470a(a)(8), eligible buildings do not qualify their owners for tax benefits such as the deduction for giving a façade easement to charity. I.R.C. § 170(b)(4)(B) (1983).

<sup>13</sup> 36 C.F.R. §§ 60.1(b)(2), 65.2(b) (1983). A building is a National Historic Landmark if it “possess[es] exceptional value or quality in illustrating or interpreting the heritage of the United States,” 36 C.F.R. § 65.4(a), and is “of exceptional value to the nation as a whole rather than to a particular state or locality.” 36 C.F.R. § 65.2.

<sup>14</sup> 36 C.F.R. § 65.4(a)(1) (1983)

<sup>15</sup> 36 C.F.R. § 65.4(a)(2).

<sup>16</sup> 36 C.F.R. § 60.4(c).

particular style of architecture or method of construction; one that was designed or constructed by a master; or one that possesses high artistic value.<sup>17</sup> Listed buildings must “possess integrity of location, design, setting, materials, workmanship, feeling and association.”<sup>18</sup> Buildings may be listed individually or as part of a historic district.<sup>19</sup>

A building may be removed from the National Register if alteration or decay destroys the qualities on which the decision to list relied.<sup>20</sup> Procedural and substantive errors during the listing process or failure to continue to satisfy the listing criteria may cause removal.<sup>21</sup> Boundary changes and relocation of the building can also result in de-listing.<sup>22</sup>

The National Register is merely a planning tool.<sup>23</sup> Listing indicates a building’s historic significance and the desirability of protecting it from “destruction or impairment.”<sup>24</sup> Listing does not, however, prevent either. The owner of a listed building has complete freedom to alter or destroy the building.<sup>25</sup>

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<sup>17</sup> 36 C.F.R. § 60.4(c).

<sup>18</sup> 36 C.F.R. § 60.4.

<sup>19</sup> 36 C.F.R. § 60.4. A district is a collection of buildings, either associated with a historic event or representative of a particular style of architecture, that forms a geographically definable area. 36 C.F.R. § 60.3(d) (1981).

<sup>20</sup> 36 C.F.R. § 60.15(a)(1) (1981).

<sup>21</sup> 36 C.F.R. § 60.15.

<sup>22</sup> 36 C.F.R. § 60.4 (1981).

<sup>23</sup> 36 C.F.R. § 60.2(a) (1981).

<sup>24</sup> 36 C.F.R. § 60.2

<sup>25</sup> 36 C.F.R. § 60.2. Listing does afford the protection of Section 106 Review. Section 106 Review is a procedural requirement that must be completed before a federal agency engages in an “undertaking” that effects any listed building or any building eligible for listing. 36 C.F.R. § 60.2. Section 106 Review gives the Advisory Council on Historic Preservation an opportunity to review the undertaking and to suggest ways to minimize any adverse impact on the building. 36 C.F.R. § 60.2(a). The Federal agency, however, is not required to implement the suggestion. 36 C.F.R. § 60.2(a). Although listing does not protect the building, it does provide certain advantages, such as tax incentives. 36 C.F.R. § 60.2(c). Also, certain federal statutes may provide additional protection to listed buildings. For example, the Surface Mining Control and Reclamation Act substantially restricts surface mining on property listed on the National Register. 30 U.S.C. § 1272(e)(3) (1977).

## B. Deduction for Charitable Contributions

### 1. Generally

Section 170 allows an income tax deduction for any “contribution or gift to or for the use of” a charity made during the taxable year.<sup>26</sup> The maximum charitable contribution deduction allowable in any given year is limited based on the taxpayer’s income, the identification of the charitable donee, and the type of property donated.<sup>27</sup> An individual taxpayer is limited to a maximum aggregate charitable contribution deduction of 50 percent of adjusted gross income.<sup>28</sup> A corporate taxpayer is limited to 10 percent of taxable income.<sup>29</sup> If a taxpayer’s aggregate charitable contributions for a given year exceed the maximum, the excess may be carried forward for five years.<sup>30</sup>

### 2. Deduction for Gifts of Façade Easements

One type of deductible charitable contribution is a qualified conservation contribution.<sup>31</sup> A gift of a façade easement is a qualified conservation contribution if the easement creates a perpetual restriction on the use of the servient estate and is given to a qualified charity exclusively for conservation purposes.<sup>32</sup> The definition of conservation purposes includes the preservation of a historic building listed on the National Register.<sup>33</sup>

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<sup>26</sup> I.R.C. § 170(c) (2000).

<sup>27</sup> I.R.C. § 170(b).

<sup>28</sup> I.R.C. § 170(b)(1)(A),(F). The limit is lower, however, if the charitable recipient is not listed in Section 170(b)(1)(A) or if the donated property is an appreciated capital asset held for more than one year. I.R.C. § 170(b)(1)(B).

<sup>29</sup> I.R.C. § 170(b)(2). For purposes of this limit, the corporation’s taxable income is calculated before certain deductions, such as net operating loss carrybacks. *Id.*

<sup>30</sup> I.R.C. § 170(d).

<sup>31</sup> I.R.C. § 170(f)(3)(B)(iii),(h). This deduction is an exception to the general rule denying a charitable deduction for a gift of less than the donor’s entire interest in the donated property. I.R.C. § 170(f)(3)(A),(B)(iii). *See generally*, C. Timothy Lindstrom, *Income Tax Aspects of Conservation Easements*, 5 Wyo. L. Rev. 1 (2005).

<sup>32</sup> I.R.C. § 170(h)(1),(2)(C),(3) (2000). Not all charities entitled to receive tax deductible gifts may receive qualified charitable contributions, only those that meet the definition of a qualified organization. I.R.C. § 170(h). A qualified organization is a charity that falls within one of the following four categories: a

The donor of a façade easement may claim a charitable contribution equal to the fair market value of the easement.<sup>34</sup> The fair market value of property is the price at which it would sell in an arms-length transaction,<sup>35</sup> but because of the dearth of sales of easements, the Regulations provide an alternative method to establish fair market value.<sup>36</sup> Absent an established market, easements are valued using the before-and-after method.<sup>37</sup> Under the before-and-after method, the fair market value of the easement equals the decline in value of the servient estate as a result of encumbering it with the easement.<sup>38</sup>

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governmental organization described in section 170(b)(1)(A)(v); a publicly supported charity described in section 170(b)(1)(A)(vi); a tax exempt organization described in section 501(c)(3) that meets the requirements of section 509(a)(2); or a tax exempt organization described in section 501(c)(3) that meets the requirements of section 509(a)(3) and is controlled by a qualified organization. I.R.C. § 170(h)(3)(A),(B). Furthermore, a charity that otherwise meets the requirements of a qualified organization is disqualified unless it has both the commitment and the necessary resources to protect the conservation purposes of the façade easement. Treas. Reg. § 1.170A-14(c)(1) (as amended in 1999). A qualified organization dedicated to the conservation of historic buildings satisfies the commitment requirement. Treas. Reg. § 1.170A-14(c)(1).

<sup>33</sup> I.R.C. § 170(h)(1)(C),(4)(A)(iv),(4)(B). The building may be listed individually or as part of a historic district. I.R.C. § 170(h)(4)(B), Treas. Reg. § 1.170A-14(d)(5)(iii). A building listed as part of a district qualifies only if the Secretary of the Interior certifies it is of historic significance to the district. I.R.C. § 170(h)(4)(B), Treas. Reg. § 1.170A-14(d)(5)(iii). See 36 C.F.R. § 67.4 for the requirements to have building certified as of historic significance to the district.

<sup>34</sup> Treas. Reg. § 1.170A-1(c)(1) (as amended in 2005). The amount of the deduction must be reduced by the amount of gain, if any, that would not be taxed as long term capital gain if the easement were sold at fair market value. I.R.C. § 170(e)(1)(A). For donations made after August 17, 2006, the Pension Protection Act of 2006 reduces the amount of the donation if the taxpayer has claimed the rehabilitation credit with respect to the building during the preceding five years. P.L. 109-289, § 1231(d), 120 Stat. 780. The amount of the reduction must correspond to the ratio of the amount claimed as a rehabilitation credit during the preceding five years to the fair market value of the building. *Id.*

<sup>35</sup> Treas. Reg. § 1.170A-1(c)(2). Fair market value is the price that a willing buyer would pay and a willing seller would accept if both have reasonable knowledge of all relevant facts and neither is under the compulsion to buy or to sell. *Id.*

<sup>36</sup> Treas. Reg. § 1.170A-14(h)(3)(i).

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* The value of the servient property before and after the grant of the easement is determined by appraisals. *Id.* The unencumbered value equals the property's value at its highest and best use. *Id.* The encumbered value must take into account any future development permitted to the owner. *Id.* The easement's fair market value must be reduced by any resulting increase in the value of other property owned by the grantor or the grantor's family. Treas. Reg. § 1.170A-14(h)(3)(ii). If the grant increases the value of the servient estate, no charitable contribution deduction is allowed. *Id.*

## C. Easements

### 1. Generally

An easement is a nonpossessory interest in another person's land.<sup>39</sup> Affirmative easements entitle the holder to enter the servient estate, the land subject to the easement, and to make use of it.<sup>40</sup> Negative easements permit the holder to prevent the owner of the servient estate from engaging in certain actions but do not afford entry onto the servient estate.<sup>41</sup>

### 2. Façade Easements

Façade easements help redress the inadequate protection afforded by the National Register. A façade easement protects the architectural features of a building by prohibiting alteration of the building's shell.<sup>42</sup> A façade easement grants the easement holder, typically a charity dedicated to the preservation of historic buildings, the right to control what alterations the current or future owners may make to the building's facade.<sup>43</sup> A façade easement also gives the charity the right to inspect the building periodically and

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<sup>39</sup> RESTATEMENT PROPERTY §450, 451 (1944).

<sup>40</sup> 3 R. POWELL, POWELL ON REAL PROPERTY, §34.02[2][c](2000).

<sup>41</sup> *Id.* The common law also categorized easements as appurtenant or in gross. An easement appurtenant attaches to a particular piece of land, the dominant estate, and benefits its owner in the physical use of the dominant estate. *Id.* § 34.02[2][d]. An easement in gross does not attach to a dominant estate; it benefits the holder without regard to the ownership or possession of another piece of land. JON W. BRUCE & JAMES W. ELY, JR., THE LAW OF EASEMENTS & LICENSES IN LAND § 2.01[2] (1995). The common law considered easements appurtenant to be assignable and to run with the dominant estate. *Id.* Easements in gross, on the other hand, were traditionally viewed as nonassignable. *Id.*

<sup>42</sup> Façade easements may be granted on either the interior or exterior of a building but most commonly are limited to the exterior. See e.g. *Rome I. Ltd., E.C. Systems, Inc., v. Comm'r*, 96 T.C. 697 (1991). The other conservation easement commonly used to protect historic buildings is the development rights easement, which restricts further development on the building's site or into the appurtenant air space. For a discussion of development rights, see Daniel Markey, Note, *Money from Heaven: Should Qualified Air Rights Donations be Characterized as Interests in Land or Buildings? Why does it Matter?*, 50 Clev. St. L.Rev. 283, 286 (2002). Applicable for donations made after July 25, 2006, the Pension Protection Act of 2006 requires façade easements encumbering buildings located in registered historic districts to protect the entire exterior of the building. P.L. 109-280 § 1231(a)(1), 120 Stat. 780.

<sup>43</sup> See e.g. BARRETT & NAGEL, *supra* note 4, at 95-107.

to require the owner to correct any violations of the easement.<sup>44</sup> Some façade easements include a covenant committing the donor to undertake all repairs to the façade.<sup>45</sup> The covenant specifies the standard to which the repairs must conform<sup>46</sup> and may include an agreement to maintain the façade in its current, or other specified, condition.<sup>47</sup>

The Tax Code and the Regulations specify certain criteria that a façade easement must satisfy if the donor wants to claim a charitable contribution deduction.<sup>48</sup> These requirements, aimed mostly at ensuring that the conservation purpose is protected in perpetuity<sup>49</sup> and the donation is made exclusively for conservation purposes,<sup>50</sup> distinguish façade easements from other easements in certain key respects.

First, the conservation purpose of the façade easement must be protected in perpetuity.<sup>51</sup> Recognizing, perhaps, that events beyond the control of both the donor and the charity may extinguish an easement,<sup>52</sup> the Regulations consider this requirement satisfied if the donor takes reasonable precautions to prevent the easement from being extinguished.<sup>53</sup> These precautions include incorporating in the grant legally enforceable restrictions preventing alteration of the façade.<sup>54</sup> Provided reasonable precautions are

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<sup>44</sup> Treas. Reg. § 1.170A-14(g)(5)(D)(ii) (as amended in 1999).

<sup>45</sup> BARRETT & NAGEL, *supra* note 4, at 96-97.

<sup>46</sup> *Id.* See also *supra* note 61.

<sup>47</sup> BARRETT & NAGEL, *supra* note 4, at 96-97.

<sup>48</sup> See Treas. Reg. § 1.170A-14(g).

<sup>49</sup> I.R.C. § 170(h)(2)(C) (2000).

<sup>50</sup> I.R.C. § 170(h)(1)(C).

<sup>51</sup> I.R.C. § 170(h)(1)(A), (2)(C).

<sup>52</sup> See Jeffrey Tapick, Note, *Threats to the Continued Existence of Conservation Easements*, 27 Colum. J. Envtl. L. 257 (2002).

<sup>53</sup> Treas. Reg. § 1.170A-14(g)(3) (as amended in 1999).

<sup>54</sup> Treas. Reg. § 1.170A-14(g)(1). To be legally enforceable, the easement must be recorded. *Satullo v. Commissioner*, TC Memo 1993-614, *aff'd* 67 F.3d 314 (11<sup>th</sup> Cir. 1995). Other precautions include subordinating any existing mortgages to the easement, Treas. Reg. § 1.170A-14(g)(2), and including language in the grant prohibiting the charity from transferring the easement to anyone other than another qualified charity. Treas. Reg. § 1.170A-14(c)(2).



taken, the conservation purpose is deemed protected in perpetuity notwithstanding the remote possibility the easement may be extinguished.<sup>55</sup>

Second, a façade easement must protect the charity in the event the easement is extinguished by allocating a portion of any post-extinguishment sales proceeds to the charity.<sup>56</sup> The charity's share of the sales proceeds is determined by reference to the decline in value of the servient property caused by the grant of the easement.<sup>57</sup> The charity's percentage of the sales proceeds must equal the percentage by which the value of the servient property declined as a result of the grant of the easement.<sup>58</sup> In essence, the minimum percentage provision treats the creation of the façade easement as giving the charity a percentage of the servient estate equal to the percentage of the servient estate's value that the donor deducts as a charitable contribution.<sup>59</sup>

Subject to certain restrictions, the owner of the servient estate may use the property in any manner, so long as such use does not conflict with the easement's conservation purpose or any other significant conservation purpose.<sup>60</sup> If the building is within a historic district, any permissible future development or rehabilitation must conform to the standard applicable within the district.<sup>61</sup>

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<sup>55</sup> Treas. Reg. § 1.170A-14(g)(3).

<sup>56</sup> Treas. Reg. § 1.170A-1(g)(6). If the façade easement is extinguished as a result of condemnation, the charitable easement holder will share in the proceeds unless prohibited by state law. Treas. Reg. § 1.170A-14(g)(6)(ii). The charitable easement holder may transfer the easement only to another qualified organization and only if the transferee agrees to carry out the conservation purposes of the façade easement. Treas. Reg. § 1.170A-14(c)(2).

<sup>57</sup> Treas. Reg. § 1.170-1(g)(6).

<sup>58</sup> Treas. Reg. § 1.170A-14(g)(6) (as amended in 1999). The percentage by which the servient estate's value declines equals the ratio, at the time of the grant of the easement, of the value of the easement to the unencumbered value of the servient estate. *Id.*

<sup>59</sup> See discussion *supra* notes 34-38 and accompanying text.

<sup>60</sup> Treas. Reg. § 1.170A-14(e)(2). Both new and existing uses are permitted. *Id.* The use cannot unduly interfere with any other significant conservation interest. *Id.* Surface mining is generally prohibited. I.R.C. § 170(h)(5)(B) (2000).

<sup>61</sup> Treas. Reg. § 1.170A-14(d)(5) (as amended in 1999).

A gift of a façade easement must provide a public benefit, a requirement that is satisfied only if the public has access to the protected features.<sup>62</sup> Visual access is sufficient, however.<sup>63</sup> If the façade cannot be seen from a public way, physical access must be provided on a regular basis to the extent consistent with the preservation of the protected features.<sup>64</sup>

### III. Charitable Contribution Deduction for Payments Pursuant to Affirmative Agreements in Easements

Amounts expended to repair a façade are deductible as a charitable contribution if the donor's payment is a "contribution or gift to or for the use of" the charitable easement holder.<sup>65</sup> In the situation considered by this article, where the donor's promise to maintain the façade is given as part of the gift of the façade easement, the donative intent applicable to the gift of the façade easement also should be applicable to the promise to maintain. Consequently, the requisite donative intent for the transfer to be a "contribution or gift" should be satisfied.<sup>66</sup> Deductibility will depend on whether there is a transfer "to or for the use of" the charitable easement holder. This article argues that at least two persuasive arguments in favor of deductibility exist. To the extent the charity

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<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> I.R.C. § 170(c). *See* discussion *infra* Part III.B.

<sup>66</sup> Courts interpret the "contribution or gift" requirement to speak to the donor's intent; however, they differ with respect to the exact intent required. *Compare* DeJong v. Commissioner, 309 F.2d 373 (9th Cir. 1962); Singer Co. v. United States, 449 F.2d 413 (Ct. Cl. 1971); Oppewal v. United States, 468 F.2d 1000 (1st Cir. 1972). According to the Supreme Court, "[t]he sine qua non of a charitable contribution is a transfer of money or property without adequate consideration. The taxpayer, therefore, must at a minimum demonstrate that he purposefully contributed money or property in excess of the value of any benefit he received in return." United States v. American Bar Endowment, 477 U.S. 105, 118 (1986). Consequently, donors who pay all maintenance expenses even though the façade easement does not obligate them to do so and subsequent purchasers of the servient property may also have an argument that a portion of their maintenance expenses should be considered a charitable contribution. Such arguments differ from the one considered by this article in that the taxpayer must establish the existence of donative intent and are beyond the scope of this article.

possesses and is relieved of the obligation to maintain the façade, the donor's payment should be treated either as an indirect transfer to the charity or as a gift of services entitling the donor to deduct any incidental expenses.

A. The Charity's Obligation to Maintain the Façade

As a general rule, the holder of an easement is obligated to repair and maintain the property subject to the easement.<sup>67</sup> The general rule provides that the obligation to repair rests exclusively with the easement holder; the owner of the servient estate is relieved of any duty to repair.<sup>68</sup> When the nature of the easement is such that both parties use it, such as a right of way, some courts continue to find the easement holder exclusively obligated to maintain the property.<sup>69</sup> Others apportion the obligation based on use.<sup>70</sup> The parties may alter the foregoing rules by agreement.<sup>71</sup>

In jurisdictions that apply the general rule to façade easements, the obligation to repair the façade rests exclusively with the charitable easement holder or is shared by the charity and the donor. Courts may question whether the general rule should apply to conservation easements, which are generally viewed as negative easements.<sup>72</sup> Although the application of the general rule to all conservation easements is a question beyond the scope of this article, several compelling reasons exist for applying it to façade easements.

First, valid questions can be raised regarding the characterization of a façade easement as a negative easement.<sup>73</sup> A negative easement does not permit the holder to

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<sup>67</sup> *E.g.*, *Lynch v. Keck*, 263 N.E.2d 176, 182 (1970) (quoting 28 C.J.S., Easements, § 94); *Shapiro v. Burton*, 502 N.E.2d 545, 549 (1987). *See also* BRUCE & ELY, *supra* note 41, at § 8.02[1][a].

<sup>68</sup> *E.g.*, *Flower v. Valentine*, 482 N.E.2d 682, 687 (1985); BRUCE & ELY, *supra* note 41, at § 8.02[1][a].

<sup>69</sup> *Lynch*, 263 N.E.2d at 182 (quoting 28 C.J.S., Easements, § 94); *Seller v. Powell*, 815 P.2d 448, 449 (1991).

<sup>70</sup> *Lakeland Property Owners Ass'n v. Larson*, 459 N.E.2d 1164, 1170 (1984).

<sup>71</sup> *National Exch. Bank v. Cunningham*, 46 Ohio St. 575, 589 (1989).

<sup>72</sup> *See* discussion *supra* notes 39-41 and accompanying text.

<sup>73</sup> *See e.g.*, POWELL, *supra* note 40, at §34A.01.

enter and use the servient estate;<sup>74</sup> it has been described as no more than a “veto power.”<sup>75</sup> The holder of a façade easement, on the other hand, must have access to the façade<sup>76</sup> and must be able to inspect the façade to ensure compliance with the terms of the easement.<sup>77</sup> Either or both of these requirements may necessitate entry onto the servient estate. Furthermore, some easements may explicitly grant the easement holder the right to enter and perform any repairs not made by the donor or to repair to its satisfaction any violations of the easement’s restrictions.<sup>78</sup> To the extent the charity must enter the servient estate, the façade easement more closely resembles an affirmative easement than a negative one.

Regardless of whether it is considered affirmative or negative, the purpose of a façade easement dictates that the obligation to repair rests with the charity. An easement holder has the “right to do whatever is reasonably convenient or necessary in order to enjoy fully the purposes for which the easement was granted.”<sup>79</sup> This rule grants an easement holder the right to undertake all repairs and improvements necessary for the enjoyment of the easement.<sup>80</sup> Because the purpose of a façade easement is to preserve the architectural features of the building, not simply to prevent changes to the façade, fulfillment of such purpose suggests that the obligation to repair the façade and any structural problems that may threaten the façade should rest exclusively with the

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<sup>74</sup> *Id.* at §34.02[2][c].

<sup>75</sup> *Id.*

<sup>76</sup> Treas. Reg. § 1.170A-14(d)(5)(iv)(A) (as amended in 1999). Access must not only be granted to the easement holder but to the public. *Id.*

<sup>77</sup> Treas. Reg. § 1.170A-14(g)(5)(ii).

<sup>78</sup> Subject to the requirements of the Tax Code and Regulations, the parties may negotiate any terms they desire.

<sup>79</sup> BRUCE & ELY, *supra* note 41, at §8.02[1][a].

<sup>80</sup> *Id.* citing Professional Executive Ctr. v. LaSalle Nat’l Bank, 570 N.E.2d 366, 383 (1991). This right is always subject to the general caveat that an easement holder cannot increase the burden on the servient estate. *Id.*

easement holder. Preservation demands *inter alia*: control over the quality of materials and craftsmanship used; saving a building's distinctive features, such as finishes, construction techniques, and craftsmanship;<sup>81</sup> repairing, rather than replacing, deteriorated historic features whenever possible;<sup>82</sup> and avoiding the use of destructive methods or treatments, such as chemical treatments or sandblasting.<sup>83</sup> Above all, preservation demands control to decide which repairs are economically viable and which are not.<sup>84</sup> Imposing the obligation to repair on the charitable easement holder affords it sufficient control to ensure that repairs preserve, rather than destroy, the protected features. If the charitable easement holder has no obligation to maintain the façade, it is less able to insure fulfillment of the purpose of the façade easement.<sup>85</sup>

Requiring the charity to shoulder at least partial responsibility for repairs is further warranted because the benefits of the repairs inure to the easement holder as well as to the owner of the servient estate. Encumbering property with an easement reduces its value. When the easement is extinguished, the property value increases. For most easements, the property owner enjoys the full benefit of that increase in value. But, the rules governing façade easements give a portion of the post-termination sales proceeds to the easement holder. The amount payable to the easement holder includes a portion of the any increase in the value of the property resulting from the repairs.

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<sup>81</sup> See 36 C.F.R. § 67.7(b)(5) (1990).

<sup>82</sup> If historic features must be replaced, the work should be adequately documented. 36 C.F.R. § 67.7(b)(6).

<sup>83</sup> See 36 C.F.R. § 67.7(b)(7).

<sup>84</sup> See 36 C.F.R. § 67(b).

<sup>85</sup> Although strong arguments exist for charging the easement holder with the exclusive obligation to maintain the façade, apportionment is more appropriate. Both the donor and the charity use the façade and benefit from the maintenance. Furthermore, nature, not use, causes much of the wear and tear. The problem with apportionment is determining the extent of the charity's use. The charity uses the property by conserving it and providing access to the public. Gauging the frequency of public access may be impossible in many situations. This article solves that problem by apportioning the obligation based on economic benefit to the charity and the donor. See *infra* notes 137-141 and accompanying discussion.

B. Payment of Maintenance Expenses as an Indirect Contribution to Charity

To the extent the general rule imposes the obligation to repair on the charity, a donor who pays for a repair makes an indirect contribution to the charity. Financially, the donor and charity are in the same position as if each paid their respective share of the cost and, then, the donor reimbursed the charity for its out-of-pocket expense. The donor's agreement in the grant to assume responsibility for all repairs constitutes a promise to make gifts in the future, which should give "rise to a charitable contribution [when] payment is actually made."<sup>86</sup>

Both general tax principles and case law interpreting the charitable contribution deduction support the argument that satisfaction of the charity's obligation is a deductible indirect contribution to the charity. In *Old Colony Trust Co. v. Commissioner*, the Supreme Court addressed the question of whether an employer's payment of an employee's federal tax liability was income to the employee.<sup>87</sup> Holding in the affirmative, the Supreme Court said "[i]t is therefore immaterial that the taxes were paid directly over to the Government. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."<sup>88</sup>

While *Old Colony Trust* dealt with the question whether discharge of a liability by a third party creates gross income, the principle underlying its holding, that discharge of one's obligation is equivalent to receipt of the amount expended for the discharge, is equally applicable in the context of determining whether a donor has made a contribution to the charity.

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<sup>86</sup> Douglas v. Commissioner, T.C. Memo 1989-592.

<sup>87</sup> 279 U.S. 716, 720 (1929).

<sup>88</sup> *Id.* at 729.

In the charitable contribution context, *Douglas v. Commissioner* stands for the proposition that payment of a charity's liability is a contribution to the charity.<sup>89</sup> Mr. Douglas, a Greek immigrant and self-made man, was approached by a cash-strapped Greek Orthodox church trying to purchase a church building.<sup>90</sup> Mr. Douglas agreed to purchase the property and to pay the mortgage until the church was in a position to buy the property from him.<sup>91</sup> Shortly after he purchased the property, Mr. Douglas deeded 20 percent to the church, free and clear of any liability for the mortgage, and continued to pay 100% of the mortgage payments.<sup>92</sup> The court held that Mr. Douglas had made charitable contributions equal to 20% of the mortgage payments because, although the church was not personally liable for the mortgage, its interest in the property was subject to the mortgage.<sup>93</sup>

The holding in *Douglas* is consistent with the principle enunciated by the Supreme Court in *Old Colony Trust*. A third party's payment of an amount that the charity would otherwise have to bear is indistinguishable from the situation in which the third party pays the charity and the charity satisfies the obligation.

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<sup>89</sup> TC Memo 1989-592, 1989 Tax Ct. Memo LEXIS 590\*.

<sup>90</sup> *Id.* at \*8.

<sup>91</sup> *Id.* at \*10.

<sup>92</sup> *Id.* at \*11.

<sup>93</sup> *Id.* at \*27.

### C. Payment of Maintenance Expenses Treated as Gift of Services

The second argument is that, if the charity is obligated to repair the property subject to the easement, the donor who maintains the property effectively makes a gift of the maintenance services that the charity would otherwise be required to undertake. Treasury Regulation 1.170A-1(g) states that a gift of services is not deductible, but unreimbursed expenses incurred in connection with such a gift are.<sup>94</sup> Such unreimbursed expenses must be “directly connected with and solely attributable to the rendition of such volunteer services.”<sup>95</sup> Furthermore, the impetus for the services must be the charitable work.<sup>96</sup> If the unreimbursed expenses are not directly connected with the gift of services, no charitable deduction is allowed even though the charity may derive a benefit.<sup>97</sup>

A donor who gratuitously agrees as part of the gift of a façade easement to assume the charity’s share of the maintenance does so for the same reasons prompting the gift of the façade easement. If the donor pays a third party to perform the maintenance, the cost is directly attributable to the donor’s gift of the maintenance services; the contractor is the instrument by which the donor performs the services.

*Rockefeller v. Commissioner* stands *inter alia* for the proposition that amounts paid to compensate a third party hired to perform the donated services are unreimbursed expenses incident to the rendition of services within the meaning of Treasury Regulation 1.170A-1(g).<sup>98</sup> John D. Rockefeller, 3<sup>rd</sup> and David Rockefeller (collectively the “Rockefellers”) and other family members shared the expenses of operating the

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<sup>94</sup> Treas. Reg. § 1.170A-1(g) (as amended in 2005).

<sup>95</sup> Rev. Rul. 56-509, 1956-2 C.B. 129.

<sup>96</sup> *Orr v. United States*, 343 F.2d 553, 556 (5th Cir. 1965); *Smith v. Commissioner*, 60 T.C. 988, 992-993 (1973).

<sup>97</sup> *Saltzman v. Commissioner*, 54 T.C. 722, 724 (1970).

<sup>98</sup> 676 F.2d 35 (2d Cir. 1982).



Rockefeller Family Joint Office, which rendered various services to the Rockefellers.<sup>99</sup> The Rockefellers used the staff *inter alia* to conduct their philanthropic activities and to render services to various charities.<sup>100</sup> The court held the Rockefellers were entitled to deduct the unreimbursed expenses incident to rendering service to charity, including the portion of their staff's salary attributable to the staff's rendition of services to the various charities at their behest, as a contribution "to" charity.<sup>101</sup>

*Archbold v. United States* lends further support to the argument that Treas. Reg. §1.170A-1(g) allows the donor to claim a charitable contribution deduction for the charity's share of maintenance expenses.<sup>102</sup> In 1924 Anne Archbold gave the United States government some land located in the District of Columbia to be used as a park.<sup>103</sup> In the 1950s the District of Columbia proposed construction of a highway through the park.<sup>104</sup> Mrs. Archbold filed suit to enjoin the project and claimed a charitable contribution for her attorneys' fees.<sup>105</sup> Referring to the predecessor to Treas. Reg. §1.170A-1(g), the court stated "if a deduction is allowable for expenses incident to the performance of nondeductible services, it would seem to follow, a fortiori, that incidental expenditures in the making of a deductible gift would be deductible."<sup>106</sup> Because the legal fees were "caused by, and directly attributable to ... attempts to destroy ... the park

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<sup>99</sup> *Id.* at 37.

<sup>100</sup> *Id.* at 37.

<sup>101</sup> *Id.* at 37. The question in *Rockefeller* turned on whether such unreimbursed expenses were deductible as a contribution "to" or "for the use of." *Id.* The Internal Revenue Service never questioned whether payments to a third party to induce such party to render services to a charity were unreimbursed expenses as contemplated by the Regulation. *Id.* Rather, the dispute arose because during the years in issue, contributions "to" a charity could be deducted without limit, but contributions "for the use of" were subject to a limit. *Id.* at 39.

<sup>102</sup> 444 F.2d 1120 (Ct. Cl. 1971).

<sup>103</sup> *Id.* at 1120.

<sup>104</sup> *Id.* at 1121.

<sup>105</sup> *Id.*

<sup>106</sup> *Id.* At 1123.

... [they were] incidental to the original gift and ... deductible.”<sup>107</sup> That the expenditures for legal fees occurred a considerable time after the gift was irrelevant.<sup>108</sup>

The donor’s assumption of a charity’s share of maintenance expenses is also “caused by, and directly attributable to” efforts to preserve the donor’s gift. Safeguarding a historic façade with an easement is pointless unless the façade is adequately maintained. The donor’s agreement to maintain the façade prevents time and the elements from destroying the gift and is an important element of the gift. So important, in fact, that one commentator has suggested that such an agreement should be implied in every gift.<sup>109</sup>

*Douglas, Rockefeller, and Archbold* all support the allowance of a charitable contribution deduction for at least a portion of the cost of maintaining a building encumbered by a façade easement. *Davis v. United States*,<sup>110</sup> decided subsequently, holds that a contribution “for the use of” a charity is one made in a “legally enforceable trust ... or similar legal arrangement.”<sup>111</sup> Because the scope of *Davis* is unclear, consideration of whether *Davis* undermines this support is necessary.

*Davis* raises two pertinent questions. One, are indirect contributions made “for the use of” a charity? If so, the donor’s deduction cannot be predicated on the theory of an indirect contribution unless the façade easement satisfies the requirements of a “legally enforceable trust ... or similar legal arrangement.”<sup>112</sup> Two, does *Davis* preclude

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<sup>107</sup> *Id.* At 1124.

<sup>108</sup> *Id.*

<sup>109</sup> POWELL, *supra* note 40, at §34A.04[3][a].

<sup>110</sup> 495 U.S. 472 (1990).

<sup>111</sup> *Id.* at 485.

<sup>112</sup> Structuring façade easements to meet the requirements of a “trust or similar legal arrangement” should not be too difficult. In fact, for many existing façade easements, a strong argument can probably be made that the easement is sufficiently similar to a trust to satisfy the requirements of the *Davis* Court. *Davis* states that “[a] defining characteristic of a trust arrangement is that the beneficiary has the legal power to enforce the trustee’s duty to comply with the terms of the trust.” *Id.* at 483 (citing 3 W. Fratcher, Scott on Trusts § 200 (4<sup>th</sup> ed. 1988)). Most façade easements give the charity the right to compel the donor to comply with the restrictions of the easement. See e.g., NAGEL & BARRETT, *supra* note 4, at 102. A

treating amounts paid to a third party to perform one's donated services as unreimbursed expenses as contemplated by Treasury Regulation 1.170A-1(g)?<sup>113</sup>

*Davis* addressed *inter alia* the question of whether amounts paid by Mr. and Mrs. Davis to their missionary sons to cover the sons' living expenses were contributions "for the use of" their church.<sup>114</sup> The Davises and their sons belong to the Church of Jesus Christ of Latter-day Saints (the "Mormon Church"), which operates a voluntary missionary program for young men, mostly aged 19 to 22.<sup>115</sup> Both of the sons volunteered to spend two years as missionaries.<sup>116</sup>

In accordance with the procedures it followed at the time, the Mormon Church established the amount needed for living expenses based on a missionary's assignment and then looked to his parents for the money.<sup>117</sup> If the parents were unable to provide the funds, the Mormon Church tried to find another member to cover the missionary's costs.<sup>118</sup> Failing that, the Mormon Church paid the expenses from its funds.<sup>119</sup> Church policy was to have the support money sent directly to the missionary in order to "foster[] the church doctrine of sacrifice and consecration in the lives of its people" and to simplify bookkeeping.<sup>120</sup> The Church provided guidance to the missionaries with respect to how the funds should be spent, telling them not to squander the funds on frivolities, but

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complete discussion of the similarities between a façade easement and a trust is beyond the scope of this article. See Alexander R. Arpad, *Private Transactions, Public Benefits, and Perpetual Control over the Use of Real Property: Interpreting conservation Easements as Charitable Trusts*, 37 Real. Prop. Prob. & Tr. J. 91 (2002).

<sup>113</sup> Treas. Reg. §1.170A-1(g) (as amended in 2005). *Davis* does not invalidate Regulation 1.170A-1(g) because unreimbursed expenses are considered to be contributions "to," not "for the use of" a charity. *Rockefeller*, 676 F.2d at 42; Rev. Rul. 84-61, 1984-1 C.B. 39.

<sup>114</sup> *Davis*, 495 U.S. at 478.

<sup>115</sup> *Id.* at 475.

<sup>116</sup> *Id.* at 475.

<sup>117</sup> *Id.* at 474.

<sup>118</sup> *Id.* at 474.

<sup>119</sup> *Davis*, 495 U.S. at 474.

<sup>120</sup> *Id.*

did not require advance approval of expenditures.<sup>121</sup> The missionaries were required to report their expenditures to the church.<sup>122</sup>

After their sons promised to abide by the Church's restrictions on spending, Mr. and Mrs. Davis deposited the necessary funds into each son's personal checking account.<sup>123</sup> The sons used the money for "rent, food, transportation and personal needs" while serving as missionaries.<sup>124</sup>

The Davises advanced two arguments to support a charitable contribution deduction.<sup>125</sup> They argued that the amounts were contributions "for the use of" the Mormon Church.<sup>126</sup> Alternatively, they argued the amounts were deductible as unreimbursed expenses incurred incident to the rendition of services to the Mormon Church.<sup>127</sup>

In support of their first argument, the Davises argued that "for the use of" should be construed broadly to mean "the entire array of fiduciary relationships in which one person conveys money or property to someone else to hold or employ in some manner for the benefit of a third person."<sup>128</sup> While recognizing that section 170(c) could be read to support that interpretation, the Court found the legislative history indicated Congress added "for the use of" as a response to the Internal Revenue Service's contention that the language "contributions or gifts to" charity did not encompass donations in trust for the

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<sup>121</sup> *Id.* at 475. The Church also exercised far greater control over the missionaries than a normal employer or charitable recipient of volunteer services would. The church not only established the number of hours to be devoted to missionary activities it also controlled the missionary's free time, forbidding many activities, such as dating. *Id.*

<sup>122</sup> *Id.* at 475.

<sup>123</sup> *Id.* at 475-6.

<sup>124</sup> *Davis*, 495 U.S. at 476.

<sup>125</sup> *Id.* at 477.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *Id.* at 479. Citing Brief for Petitioner 17.

benefit of a charity.<sup>129</sup> Consequently, the Court held that a gift “for the use of” a charity is one made in trust or in some similar legal arrangement.<sup>130</sup> The payments at issue did not qualify because they were not made pursuant to a legal arrangement that satisfied the definition of a trust.<sup>131</sup> Although this definition does “not require that the [charity] take actual possession of the contribution, it nevertheless reflects that the beneficiary must have significant legal rights with respect to the disposition of donated funds.”<sup>132</sup>

The Davises never argued that they had made an indirect contribution to the Mormon Church that was deductible as a contribution “to” charity. Even if they had, Davis is factually distinguishable from the situation addressed in this article. The Davises were not satisfying a legal obligation of the Mormon Church. Their sons were volunteers, not employees; the Church had no legal obligation to pay the expenses associated with the son’s gift of services. The Church voluntarily paid the living expenses if no sponsor could be found because it benefited from the missionaries’ services, not because it had a legal obligation to do so.

Contrast *Davis* with a donor’s payment of a charity’s share of maintenance expenses. Not only does the obligation to repair the facade rest with the charity absent an assumption by the donor, but the charity cannot choose to ignore its obligation if the

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<sup>129</sup> *Davis*, 495 U.S. at 479-80.

<sup>130</sup> *Id.* at 485. While the interpretation of “for the use of” adopted by the Supreme Court in *Davis* appears to accord with the legislative history, the outcome appears contrary to common sense and exalts form over substance. One cannot help but wonder whether the *Davis* court was unduly influenced by the fact that the missionaries were the Davis’ sons and the natural object of their bounty. Would a different result have been reached if the money had come from some third-party church member who did not know the sons? If the Church determines that \$500 will support a missionary for a year and solicits donations in that amount, it seems to be nitpicking in the extreme to deny a charitable contribution deduction to a church member who donates \$500 for the support of some unknown missionary merely because the Church asks the member to mail the \$500 directly to the missionary. The primary consequence of *Davis* from a pragmatic standpoint is to require the Mormon Church to change its procedures so that it requires parents to send the money directly to the church, which then sends a check to the missionaries.

<sup>131</sup> *Id.* at 485-86.

<sup>132</sup> *Id.* at 483.

purpose of the easement is to be fulfilled. Furthermore, failure to maintain the façade is not only inconsistent with preservation, it also renders superfluous the requirement that a charity have the financial resources to preserve the easement's conservation purposes.<sup>133</sup> If not properly maintained, the façade may deteriorate to the point where the building is removed from the National Register or is demolished.<sup>134</sup> *Davis* teaches us nothing regarding the proper tax treatment of a donor's satisfaction of the charity's obligation to repair the facade.

The Davises' second argument, that the funds were unreimbursed expenses incurred incident to the rendition of services by their sons, was also rejected. Regulation 1.170A-1(g) applies only to expenses incurred by the taxpayer making the gift of services.<sup>135</sup> The sons, not Mr. and Mrs. Davis, donated the services to the church.<sup>136</sup>

Unlike the Davises, the donor of a façade easement is the one contributing the services. The donor is motivated by the desire to benefit the charitable easement holder and to serve the conservation purpose of the easement, not by a desire to benefit the contractors who will be hired to make the repairs. On the contrary, the donor expects to receive services of equivalent value to the consideration paid. And, unlike the Davises' sons, the contractors have no desire to make a gift to the charitable easement holder; the only reason they are performing services is because they are being paid full value for their efforts. The contractors assist the donor in rendering the maintenance services. As

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<sup>133</sup> Treas. Reg. §1.170A-14(c)(1) (as amended in 1999).

<sup>134</sup> See discussion *supra* notes 20-22 and accompanying text.

<sup>135</sup> *Davis*, 495 U.S. at 487.

<sup>136</sup> *Id.* at 477.

the *Davis* Court recognized, a situation in which a donor pays a third party to assist in the gift of services is inapposite to the situation presented in *Davis*.<sup>137</sup>

As the analysis above shows, *Davis* does not address the question of indirect contributions “to” a charity, nor does it prohibit the deduction of payments to independent third parties who perform services at the behest of the donor. Therefore, *Davis* does not overrule *Douglas*, *Rockefeller*, or *Archbold*, and the theories advanced by this article remain valid justifications for the existence of a charitable contribution deduction for a donor of a façade easement who agrees to assume liability for the charity’s share of maintenance expenses.

#### IV. Suggestions to Ensure Uniform Treatment for All Taxpayers

Current law provides strong support for the argument that a donor who assumes the cost of maintaining property subject to a façade easement makes additional charitable contributions every time the donor expends money for repairs, but only to the extent that state law imposes the obligation to repair on the charity. Because state law may vary with respect to the existence and extent of a charity’s obligation, relying on it to determine when a donor is entitled to claim a charitable contribution is not the best approach and may lead to disparate treatment.

Façade easements are as much creatures of federal tax law as of state law. The primary, if not sole, reason many provisions are included in façade easements is to qualify for the federal charitable contribution deduction. Donors seeking federal tax benefits should be able to rely on readily ascertainable and consistent federal rules regarding the tax consequences of their actions. The government deserves equal

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<sup>137</sup> *Id.* at 488.

consideration, as well as assurance that aggressive donors do not claim a charitable contribution deduction that is disproportionate to the benefit derived by the charity. The best way to accomplish these goals is to promulgate a federal rule, one that is easily administered, regarding how much of the donor's maintenance expenditures constitute charitable contributions.

The existing rules regarding façade easements provide a blueprint for devising a fair and easily administered rule to determine a donor's charitable contribution. Currently, the Treasury Regulations require donors to compute what percentage of the value of their servient estate is attributable to the façade easement.<sup>138</sup> That percentage, which I will call the Charitable Percentage, is established at the time of the gift and remains constant. The Charitable Percentage establishes the percentage of the value of the servient estate that the donor claims as a charitable contribution for the grant of the easement.<sup>139</sup> And, because the fair market value of a façade easement is, generally, determined by the decrease in value of the servient estate as a result of the easement grant,<sup>140</sup> the Charitable Percentage represents the loss of value to the donor from the grant. The Charitable Percentage also represents the percentage of the value of the servient estate that the Treasury Regulations treat as belonging to the charity if the façade easement is ever extinguished. In a post-termination sale, the charity must receive a portion of the sales proceeds.<sup>141</sup> And, the Charitable Percentage establishes the minimum percentage payable to the charity.<sup>142</sup>

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<sup>138</sup> Treas. Reg. § 1.170A-14(g)(6)(ii) (as amended in 1999).

<sup>139</sup> Treas. Reg. § 1.170A-14(h)(3)(i). *See supra* notes 31-38 and accompanying discussion.

<sup>140</sup> Treas. Reg. § 1.170A-14(g)(6)(ii).

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*



The Charitable Percentage can be used to fashion an easily administered rule to determine what portion of a donor's maintenance expenses should be treated as a charitable contribution. Such a rule would provide that a donor who assumes responsibility for paying all maintenance expenses makes a charitable contribution each time the donor incurs expenses for maintenance, with the amount of the contribution equaling the amount of the expense multiplied by the Charitable Percentage.

Example: Donor owns Blackacre, which has a fair market value of \$100. Donor grants a façade easement to Charity. The fair market value of the façade easement is \$20. The Charitable Percentage is 20%, the percent of the value of Blackacre that Donor gave to Charity. In the easement grant Donor agrees to pay all maintenance expenses. Several years after the gift of the façade easement Donor spends \$10 maintaining the façade. Donor's charitable contribution deduction equals 20% of the \$10, or \$2.

Determining the amount of the donor's charitable contribution by reference to the Charitable Percentage is simple. It is also fair to both the donor and the government, since it reflects the benefit to the charity from the maintenance expenses. The practical impact of this rule on a donor's tax consequences is explained below.

#### A. Tax Treatment of Maintenance Expenses

The tax treatment of the cost of maintaining a building varies depending on whether the expenditure is considered a repair or a capital improvement. Whether the building is held for income producing purposes or for personal use also effects the tax consequences.

The Tax Code characterizes maintenance costs as repairs or as capital improvements. A repair is an expenditure that keeps the building in operating condition over its probable useful life for the use for which it was acquired.<sup>143</sup> A capital

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<sup>143</sup>Midland Empire Packing Co., 14 TC 635, 640 (1950), quoting Illinois Merchants Trust Co. Executor, 4 BTA 103, 106 (1926); Treas. Reg. § 1.162-4 (1960).

improvement materially adds to the value of the building, adapts it to another use, or substantially prolongs its useful life.<sup>144</sup> Capital improvements include “replacements, alterations, improvements, or additions which prolong the life of the [building], increase its value or make it adaptable to a different use.”<sup>145</sup> The cost of capital improvements is added to the building’s basis.<sup>146</sup> Repairs, if they have any tax consequences at all, are treated as expenses.<sup>147</sup>

Whether a building is held for income producing or for personal use affects the tax treatment of both a repair and a capital improvement.<sup>148</sup> If the building is held for income producing purposes, both repairs and capital expenditures are deductible; the difference is simply one of timing. Repairs are currently deductible.<sup>149</sup> Capital expenditures, on the other hand, are deducted over their useful life through depreciation deductions.<sup>150</sup> If the building is sold before the capital improvement is fully depreciated, the balance is deducted against the sales price to determine the taxpayer’s gain or loss.<sup>151</sup>

Example: Taxpayer holds a building for income producing purposes that has an adjusted basis of \$33,000. In 2006, Taxpayer spends \$2,000 on repairs and \$7,800 for a capital improvement. The \$2,000 repair is deductible in 2006. The \$7,800 capital improvement increases the

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<sup>144</sup> Treas. Reg. § 1.162-4.

<sup>145</sup> *Midland Empire*, 14 TC at 640, quoting *Illinois Merchants Trust*, 4 BTA at 106.

<sup>146</sup> I.R.C. § 1016(a)(1) (2000). Regardless of the arguments advanced by this article, a servient owner who makes a capital improvement may be considered to make an additional qualified conservation contribution. The Internal Revenue Service has ruled that the grantor of a charitable remainder trust who makes capital improvements to the property held by the trust makes an additional contribution to the charitable remainderman. I.R.S. Priv. Ltr. Rul. 85-29-014 (April 16, 1985). A capital improvement to a façade may be viewed similarly, as an additional grant of an easement. A discussion of whether capital improvements create additional easement grants is beyond the scope of this article; however, even if they do, it is far more convenient, administratively, to determine the amount of the donor’s additional charitable deduction using the method suggested in this article than to try to determine the increase in the value of the easement created by the capital improvement.

<sup>147</sup> Treas. Reg. § 1.162-4 (1960); I.R.C. §§ 162, 212.

<sup>148</sup> Buildings held for income producing purposes include those held for investment purposes, I.R.C. § 212, as well as those used in the taxpayer’s trade or business. I.R.C. § 162.

<sup>149</sup> Treas. Reg. § 1.162-4; I.R.C. §§ 162, 212.

<sup>150</sup> I.R.C. §§ 162, 212, 167. The building’s basis is reduced to reflect depreciation. I.R.C. § 1016(a)(2) (2000).

<sup>151</sup> I.R.C. §§ 1001(a),(b), 165(a),(c).

building's basis to \$40,800 and will be depreciated over its useful life. Several years later, Taxpayer sells the building. Since making the capital improvement, Taxpayer has claimed a total of \$6,000 in depreciation of which \$1,000 was attributable to the capital improvement. Therefore, Taxpayer's adjusted basis in the building is \$34,800.<sup>152</sup> When Taxpayer sells the building, she calculates her gain or loss by deducting her basis from the sales proceeds.<sup>153</sup> If she sells for \$40,000, her gain is \$5,400 \$5,200.<sup>154</sup> If she sells for \$30,000, she realizes a \$4,800 loss, which is deductible against taxable income.<sup>155</sup> In either alternative, Taxpayer deducts the undepreciated cost of the capital improvement at the time the building is sold.

If the building is used for personal purposes, such as the owner's residence, repairs are nondeductible personal expenses.<sup>156</sup> Capital improvements still increase the building's basis;<sup>157</sup> however, depreciation deductions are no longer permitted.<sup>158</sup> If the building is subsequently sold for a gain, capital improvements are deducted to determine gain.<sup>159</sup> But, since losses from the sale of personal use property are not deductible,<sup>160</sup> if the taxpayer sells the building at a loss, some or all of the capital improvement becomes a nondeductible personal expense.<sup>161</sup>

Example: Taxpayer holds a building for personal use; the building has an adjusted basis of \$50,000. Taxpayer spends \$1,000 for repairs and \$6,000 for a capital improvement. The repairs are not deductible; the \$6,000 capital improvement increases the building's adjusted basis to \$56,000.<sup>162</sup> If Taxpayer subsequently sells the building for more than \$56,000, the capital improvement is deducted in full. If Taxpayer sells for less than \$56,000, some or all of the capital improvement is not deductible. For example, if Taxpayer sells for \$54,000, Taxpayer realizes a nondeductible loss of \$2,000. In this situation only \$4,000 of the capital improvement is deducted.

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<sup>152</sup> Depreciation deductions reduce the building's basis. I.R.C. § 1016(a)(2).

<sup>153</sup> I.R.C. § 1001(a),(b).

<sup>154</sup> I.R.C. § 1001(a).

<sup>155</sup> I.R.C. §§ 1001, 165(a)(c).

<sup>156</sup> I.R.C. § 262 (2000).

<sup>157</sup> I.R.C. § 1016(a)(2)

<sup>158</sup> I.R.C. § 262.

<sup>159</sup> I.R.C. § 1001(a)

<sup>160</sup> I.R.C. § 165(c).

<sup>161</sup> I.R.C. §§ 162, 262 (2000).

<sup>162</sup> I.R.C. § 1016(a)(1).

B. Tax Treatment if a Portion of Maintenance Expenses is Considered a Charitable Contribution

If a portion of the cost of maintaining a historic building is treated as a charitable contribution, the tax treatment of the balance is determined by the foregoing rules. The portion treated as a charitable contribution will be deductible, subject to the rules applicable to charitable contributions.

Because of the limitations applicable to charitable contributions, recharacterizing a portion of the maintenance expenses as a charitable contribution may or may not be advantageous. Depending on the taxpayer's circumstances, such treatment will either have no effect, change the timing of the deduction, disallow a deduction, or permit the deduction of an otherwise nondeductible expense.

If the historic building is held for income producing purposes, and assuming the taxpayer's contribution base is sufficient to permit immediate deduction of the charitable contribution in full, recharacterization of an expenditure that would be treated as a repair has no effect; recharacterization of one that would be treated as a capital improvement accelerates the deduction. If the taxpayer's contribution base is insufficient to allow immediate deduction, recharacterization of a repair defers a deduction that would otherwise be allowed currently; however, recharacterization of a capital improvement still accelerates the deduction, since buildings and their components have a depreciable life greater than six years.<sup>163</sup> Finally, if the contribution base is too small, there is a risk that recharacterization of either a repair or a capital improvement will result in total disallowance of a portion of the deduction.

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<sup>163</sup> See I.R.C. § 168.

Example: In 2006, Taxpayer, an individual whose contribution base, adjusted gross income, is \$50,000, donates a façade easement to charity and agrees to assume the charity's liability for a share of future maintenance expenses. The charity qualifies as a section 170(b)(1)(A) charity, which entitles Taxpayer to deduct cash contributions to the charity to the extent of 50 percent of adjusted gross income.<sup>164</sup> Taxpayer's maximum allowable charitable contribution deduction is \$25,000. The building is held for income producing purposes and has an adjusted basis of \$100,000. Assume the Charitable Percentage is 20 percent, i.e., 20 percent of all repairs and capital improvements are recharacterized as charitable contributions. Further assume that Taxpayer makes no other charitable contributions. In 2007, Taxpayer spends \$10,000 on repairs, of which \$2,000 is recharacterized as a charitable contribution. Taxpayer deducts \$8,000 as a repair;<sup>165</sup> and provided that Taxpayer's other cash donations do not exceed \$23,000, the other \$2,000 as a charitable contribution.<sup>166</sup> Alternatively, assume Taxpayer spends \$100,000 on a capital improvement of which \$20,000 is recharacterized. Taxpayer must capitalize and depreciate the \$80,000, which, if the building is used for residential rental means the recovery period is 27.5 years.<sup>167</sup> The \$20,000 charitable contribution deduction is deductible immediately or, over a maximum of 6 years if Taxpayer's other charitable contributions prevent immediate deduction. In either instance, the deduction for the \$20,000 is greatly accelerated.

If the building is held for personal use, recharacterization should almost always be beneficial. Recharacterization converts a nondeductible repair into a deductible charitable contribution. For capital improvements, recharacterization makes immediately deductible an expenditure that would, at best, be deductible only against gain at the time of sale.

Example: In 2006, Taxpayer, an individual whose contribution base, adjusted gross income, is \$50,000, donates a façade easement to charity and agrees to assume the charity's liability for a share of future maintenance expenses. The charity qualifies as a section 170(b)(1)(A) charity, which entitles taxpayer to deduct cash contributions to the charity

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<sup>164</sup> I.R.C. § 170(b)(1)(A).

<sup>165</sup> I.R.C. § 162.

<sup>166</sup> I.R.C. § 170(b)(1)(A). If Taxpayer's other cash contributions exceed \$23,000, some or a part of the \$2,000 deduction will be deferred to the next year or beyond. I.R.C. § 170(d)(1)(A). There is also a risk that the \$2,000 deduction, when coupled with Taxpayer's other cash deductions, results in the deferral of deduction for contributions of property. I.R.C. § 170(b)(1)(B).

<sup>167</sup> I.R.C. § 168 (2000).

to the extent of 50 percent of adjusted gross income.<sup>168</sup> Taxpayer's maximum allowable charitable contribution deduction is \$25,000. The building is held for personal use and has an adjusted basis of \$100,000. Assume the Charitable Percentage is 20 percent, i.e., 20 percent of all repairs and capital improvements are recharacterized as charitable contributions. Also assume Taxpayer makes no other charitable contributions. In 2007, Taxpayer spends \$10,000 on repairs, of which \$2,000 is recharacterized as a charitable contribution. Taxpayer may deduct the \$2,000 charitable contribution.<sup>169</sup> No deduction is allowed for the \$8,000 characterized as a repair. Alternatively, assume Taxpayer spends \$100,000 on a capital improvement of which \$20,000 is recharacterized. Taxpayer may deduct the \$20,000 charitable contribution deduction immediately. The remaining \$80,000 is added to Taxpayer's basis in the building and is deducted against the sales proceeds if the building is sold for a gain. To the extent Taxpayer realizes a loss on the sale of the building, the \$80,000 is not deductible.<sup>170</sup>

## V. Conclusion

To the extent a charity is obligated to maintain property subject to a façade easement, a donor's assumption of such obligation benefits the charity and furthers the conservation purposes of the easement. There are several persuasive arguments that current law considers the discharge of the charity's obligation to be an additional charitable contribution by the donor. The difficulty exists in determining the extent of the charity's obligation to maintain the façade and in assuring consistent treatment of all taxpayers. That problem is easily resolved by adopting a federal rule which determines the donor's charitable contribution without regard to the extent to which state law imposes the obligation to maintain on the charitable easement holder. The solution suggested by this article, using the Charitable Percentage to determine the amount of the charitable contribution, is easy and fair to both taxpayers and the government.

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<sup>168</sup> I.R.C. § 170(b)(1)(A).

<sup>169</sup> I.R.C. § 170(b)(1)(A). If Taxpayer's other cash contributions exceed \$23,000, some or a part of the \$2,000 deduction will be deferred to the next year or beyond. I.R.C. § 170(d)(1)(A). There is also a risk that the \$2,000 deduction, when coupled with Taxpayer's other cash deductions, results in the deferral of the deduction for contributions of property. I.R.C. § 170(b)(1)(B).

<sup>170</sup> I.R.C. § 165(c).